



U.S. SENATE COMMITTEE ON

# Finance

SENATOR CHUCK GRASSLEY, OF IOWA - CHAIRMAN

<http://finance.senate.gov>

Following are:

- (1) a statement from Sen. Grassley on the global settlement case
- (2) details of today's legislation on tax treatment of penalties

## MEMORANDUM

To: Reporters and Editors  
Re: Global settlement  
Da: Monday, April 28, 2003

Sen. Chuck Grassley, chairman of the Committee on Finance, today made the following comment on the finalization of the "global settlement" between Wall Street and the government over allegations of conflicts of interest in stock research.

"This looks like half a loaf. The documents emphasize that the \$487 million in civil penalties won't be tax deductible or reimbursed from insurance policies -- a restatement of current law. Unfortunately, that's only half the story. The material made available to me so far indicates that similar limitations on tax deductibility and insurance reimbursement do not apply to the \$387 million in disgorgement, the \$432 million in independent research, and the \$80 million in investor education. I'm concerned that the media coverage today might significantly overstate the after-tax cost and actual burden on Wall Street. I'm pleased that Senator Baucus and I are introducing legislation today that will greatly limit the ability of Wall Street to send part of today's \$1.4 billion tab to the taxpayers."

For Immediate Release  
Monday, April 28, 2003

### Grassley, Baucus Introduce Bill to Toughen Corporate Settlements

WASHINGTON – Sen. Chuck Grassley, chairman of the Committee on Finance, and Sen. Max Baucus, ranking member, today will introduce legislation to make clear how much of a government settlement can be tax deductible. If approved, the legislation will affect the \$1.4 billion conflict-of-interest settlement between the Securities and Exchange Commission and 10 Wall Street

firms. That so-called “global settlement” was finalized today.

“There’s confusion about what settlement payments are tax deductible. Compounding that is inattention from the government,” Grassley said. “Our responsibility is to end all imprecision. Otherwise, some creative people will try to get out of paying whatever they can, and the rest of the taxpayers will bear their burden. At the same time, I welcome comments from tax practitioners on possible refinements of the proposal.”

Baucus said, “I’m proud to be working together with Chairman Grassley on this important bill that will help restore faith in corporate America and make sure that the tax burden in corporate settlements falls on the offenders, not the American taxpayers. Our bill will restore common sense into these settlements -- those who have violated the law and have been instructed to pay a penalty should not be allowed to then deduct those payments. While this legislation coincides with the timing of the SEC Wall Street settlement, our bill addresses the big picture. All settlements must ensure that wrongdoers pay their fair share by clarifying the appropriate tax treatment of any penalties or fines that are imposed.”

Grassley and Baucus said confusion about what penalty payments are tax-deductible pre-dates the global settlement. Last fall, Grassley and Baucus drafted legislation to clear up the confusion, but the legislation never received committee consideration before the Senate adjourned.

Today’s legislation is based on the previous legislation. The *Government Settlement Transparency Act of 2003* applies to any settlement with any level of government – state or federal – of a violation or potential violation of the law involving penalty payments. Generally, the bill makes clear that payments made to acknowledge actual or potential violations of any law are not tax-deductible. The bill denies a deduction for any such payment, including those where there is no admission of guilt or liability and those made to avoid further investigation or litigation. Payments for real restitution to harmed people would remain tax-deductible.

The legislation wasn’t designed specifically to apply to the global settlement case, but it will apply if approved. The bill would be effective for amounts paid or incurred after today’s date, April 28, 2003.

Grassley said he was disturbed by reports that the Wall Street firms in the global settlement, which stems from allegations of stock research tainted by conflicts of interest, are likely to deduct one-third or more of their \$1.4 billion payment from their taxes. The firms’ insurance companies could foot some of the bill, too.

“Allowing businesses to deduct a big part of the settlement’s cost means taxpayers have to foot part of the bill,” Grassley said. “What the firms are bragging about, this \$1.4 billion, ends up being a lot less than \$1.4 billion. That’s a slap on wrist, not a real punishment.”

The global settlement case is one of many in which uncertainty over tax deductibility applies, Grassley said. For example, today’s USA TODAY describes a communications executive who is expected to pay \$4.4 million to charity to settle a state lawsuit accusing him of improperly profiting from a business relationship. The case raises questions about whether the executive could claim the

payment as a charitable deduction on his federal taxes, Grassley said.

Today's legislation comes after months of correspondence between Grassley, Baucus, and Sen. John McCain, chairman of the Senate Commerce, Science and Transportation Committee, and the SEC and Internal Revenue Service over whether the agencies are taking steps to ensure that the Wall Street firms involved bear the full cost of the global settlement. The SEC has said tax implications and insurance coverage questions were outside the commission's jurisdiction. The senators rejected that assertion, saying the Internal Revenue Service would take into strong consideration any language in the settlement stating that regulators did not intend the fines and other payments to be deductible. They also said that judges would take settlement language into account if Wall Street firms went to court to force insurers to cover the agreement.

"There's a void in the law that people can exploit," Grassley said. "Congress has a responsibility to fill that void with effective legislation."

## **Joint Committee on Taxation**

### **Technical Explanation of the Government Settlement Transparency Act of 2003 Denial of deduction for certain fines, penalties, and other amounts**

#### **Present Law**

Under present law, no deduction is allowed as a trade or business expense under section 162(a) for the payment of a fine or penalty to a government for the violation of any law (sec. 162(f)). The enactment of section 162(f) in 1969 codified existing case law that denied the deductibility of fines as ordinary and necessary business expenses on the grounds that "allowance of the deduction would frustrate sharply defined national or State policies proscribing the particular types of conduct evidenced by some governmental declaration thereof."

Treasury regulation section 1.162-21(b)(1) provides that a fine or penalty includes an amount: (1) paid pursuant to conviction or a plea of guilty or *nolo contendere* for a crime (felony or misdemeanor) in a criminal proceeding; (2) paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Code; (3) paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or (4) forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty. Treasury regulation section 1.162-21(b)(2) provides, among other things, that compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. 15a), as amended) paid to a government do not constitute a fine or penalty.

#### **Description of the Bill**

The bill modifies the rules regarding the determination whether payments are nondeductible payments of fines or penalties under section 162(f). In particular, the bill generally provides that amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government in

relation to the violation of any law or the investigation or inquiry into the potential violation of any law are nondeductible. The bill applies to deny a deduction for any payments, including those where there is no admission of guilt or liability and those made for the purpose of avoiding further investigation or litigation. An exception applies to payments that the taxpayer establishes are restitution.<sup>1</sup>

It is intended that a payment will be treated as restitution only if the payment is required to be paid to the specific persons, or in relation to the specific property, actually harmed by the conduct of the taxpayer that resulted in the payment. Thus, a payment to or with respect to a class broader than the specific persons or property that were actually harmed (for example, to a class including similarly situated persons or property) does not qualify as restitution. Restitution is limited to the amount that bears a substantial quantitative relationship to the harm caused by the past conduct or actions of the taxpayer that resulted in the payment in question. If the party harmed is a government or other entity, then restitution includes payment to such harmed government or entity, provided the payment bears a substantial quantitative relationship to the harm. However, restitution does not include reimbursement of government investigative or litigation costs, or payments to whistleblowers. Any self-regulatory entity that regulates a financial market or other market that is a qualified board or exchange under section 1256(g)(7), and that imposes sanctions (as one example, the National Association of Securities Dealers) is treated as a government for purposes of the proposal. To the extent provided in regulations, any other nongovernmental entity that exercises self-regulatory powers as part of performing an essential governmental function shall be treated as a government.

No inference is intended as to the treatment of payments as nondeductible fines or penalties under present law. In particular, the bill is not intended to limit the scope of present-law section 162(f) or the regulations thereunder.

### **Effective Date**

The bill is effective for amounts paid or incurred on or after April 28, 2003; however the bill does not apply to amounts paid or incurred under any binding order or agreement entered into before such date.

<sup>1</sup> The bill does not affect the treatment of antitrust payments made under section 4 of the Clayton Act, which will continue to be governed by the provisions of section 162(g).